United States Court of Appeals
for the Second Circuit

APPELLEE'S PETITION FOR REHEARING EN BANC

74-1166

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IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PHILIP HANDELMAN and ESTHER HANDELMAN

Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

ON APPEAL FROM THE DECISION OF THE UNITED
STATES TAX COURT.

PETITION FOR REHEARING AND FOR REHEARING EN BANC

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CITATIONS

PRELIMINARY STATEMENT

By decision dated January 27, 1975, this Court reversed the judgment of the United States Tax Court (William H. Quealy, Judge) pursuant to which capital gains treatment was afforded in connection with monies received by the Petitioners-Appellees (hereinafter "Taxpayer") in connection with the sale of stock of a closely held corporation (1483).* Ninety-Five Thousand ($95, 000. 00) Dollars had been received as partial payment made by the purchasers for the Taxpayer's stock of Graphic Arts Exhibits Building, Inc. (hereinafter "Graphic Arts"), a company organized for the purpose of constructing and leasing space in a building to be constructed at the New York World's Fair which was to have been held in 1964-1965. The total purchase price agreed upon was $221, 000 (A. 57). In addition to the aforesaid partial payment, the purchasers had executed three notes payable to Taxpayer in the respective amounts of $50, 000, $17, 000, and $59, 000 and, in addition, had executed a note in the amount of $48, 000 in payment of additional shares which the purchasers were buying from Dr. A. Alfred Solomon (1485). In order to effectuate the sale, the Taxpayer entered into an escrow agreement with the purchasers and an

*Parenthetical numerical references are to pages of this Court's decision . References preced by "A" are to the appendix, and those preceded by "Ex. Vol." are to the separately bound exhibit volume.

officer of the Chemical Bank whereby shares of the Taxpayer and Dr. A. Solomon were put into escrow, with directions to the escrow agent to deliver certain of those shares to the purchasers upon payment of the $50,000, $17,000 and $48,000, with the remaining shares to be delivered after payment of the additional note for $59,000 (1485, Ex. Vol. 69-70). None of the notes were in fact paid by the time stipulated, the escrow was terminated and the stock returned to the Taxpayer (1486). After default, two more successive escrow arrangements were entered into, and upon the purchasers' subsequent defaults, the escrows were terminated and the stock returned to the Taxpayer (1486).

Thereafter, Taxpayer as well as Dr. A.A. Solomon, commenced an action against the purchasers on the unpaid notes, and the New York State Supreme court granted summary judgment against the purchasers in both cases. (Solomon v. Van de Maele, 21 A.D. 2d 316, 250 N.Y.S. 2d 772(1964), Ex. Vol. 18, 35). Meanwhile, the corporation defaulted on its lease, the World's Fair terminated, and, in 1965, the company was dissolved by proclamation of the Secretary of State of New York for non-payment of taxes (1487).

Thereafter, in April, 1971 the judgment obtained by Taxpayer against the purchasers was settled in accordance with an agreement providing for a payment by the purchasers of an additional $89,500 in return

for a general release from the Taxpayer, the three notes held by him and the certificates of Graphic Arts stock (1487, Ex. Vol. 20-21).

The issue, then, as defined by this Court, was whether there was a " sale or exchange" within the meaning of § 1222(3) of the Internal Revenue Code, so that the $95,000 received by Taxpayer was long term capital gain (1487). The Commissioner had imposed a deficiency on the theory that the $95,000 received by the Taxpayer was forfeited by the purchasers and was in the nature of liquidated damages, therefore taxable as ordinary income (Ex. Vol. 16). The Tax Court, in holding that there was no forfeiture either by agreement or under the applicable laws of New York State said:

> "When the purchasers failed to pay the notes when due, and after the expiration of each extension or new escrow set up by the petitioner, the petitioner could elect either to take back the stock and call the whole deal off or to file suit on the notes and be prepared to deliver the stock to the purchasers. See N. Y. Pers. Prop. Law, Sections 134 & 144 (McKinney 1962) ; Solomon v. Van de Maele, supra. See also Doyle's Main Motors v. Davis, 118 N. Y. S. 2d 867 (Sup. Ct. 1963).
>
> If petitioner had elected to terminate the agreement, not only would his right ultimately to collect on the notes be jeopardized, but he might be called upon to refund the cash payments which had been received by him because " a provision for liquidated damages is never read into a contract by implication ***. "People v. Condor of Americas, Inc., 252 NYS 2d 619 (Sup. Ct. 1964) ; see also Winkelman v. Windelman, 204 NYS 63 (Sup. Ct. 1924) ; cf. Pirman v. Kurtz, 45 NYS 2d 508 (Sup. Ct. 1943). "***" Recission

can be effective only by returning or tendering back the consideration received. "Gilbert v. Rothschild, 80 NY 66, 19 NE 2d 785 (1939), and cases there cited.

Obviously, it was to the advantage of the petitioner not to claim forfeiture but rather to proceed with the collection of the notes, in which event the petitioner would have to be prepared to make delivery of the stock. "

This Court, in reversing the Tax Court, held that

" the payments were more in the nature of liquidated damages ; as such they were taxable as ordinary income" (1489) .

In so holding this Court has departed from a long line or precedents, and has rendered a decision which will have an enormous impact upon the administration of the capital gains provision of the Internal Revenue Code, resulting in the denial of capital gains treatment to transactions that have heretofore been afforded such preferred treatment in accordance with legislative intent. The decision, as will hereinafter be set forth, resulted from a misapprehension both of the facts and the applicable law.

ARGUMENT

THE SUMS RECEIVED BY TAXPAYER DID NOT CONSTITUTE A FORFEITURE AND WERE NOT IN THE NATURE OF LIQUIDATED DAMAGES. RATHER, THEY WERE RECEIVED IN CONNECTION WITH THE SALE OF STOCK AND SHOULD BE AFFORDED CAPITAL GAINS TREATMENT.

This Court cited a number of cases in support of the proposition, which is not contested by taxpayer, that where an agreement to sell a capital asset is never culminated but remains executory, the seller retains control and dominion over the asset, and the seller retains partial payments which have been made by the purchaser as liquidated damages, then the seller cannot obtain the benefit of the capital gains provisions. * The rationale for such proposition was stated with clarity in A. M. Johnson, 32 B. T. A. 156, 161, where an agreement between the seller and the purchaser contained a provision that if the sale was not consummated within a stipulated period, then the stock which had been placed in escrow along with a $45, 000 deposit was to be turned over to the seller as liquidated damages. The Court there held:

> "The payment was made not because of the disposition of a capital asset. It was a payment of liquidated damages for failure to complete a sale.
>
> After the payment, the petitioner had exactly the same capital assets as before the transaction was entered into." (emphasis supplied)

In every one of the cases cited by this Court in its decision, there was a specific provision either in the agreement of sale, or in an agreement

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*Mittleman v. Commissioner, 56T. C. 171, 178-9(1971), aff'd 464 F. 2d 1393 (3rd Cir. 1972) ; Smith v. Commissioner, 50T. C.273 (1968), aff'd 418F2d573 Melone v. Commissioner, 45 T.C. 501 (1966) Binns v. United States 385 F. 2d 159 (6th Cir. 1969) ; Boatman v. Commissioner, 32 T. C. 1188, 1192 (1959); Johnson v. Commissioner, 32 BTA 156, 161 (1935).

reached after the purchasers' default, that the seller in addition to keeping his stock could keep the amounts paid to him on account of the purchase price as liquidated damages, and that the purchasers would thereby be relieved of any further liability under the contract of sale. There was no such agreement in the instant case. Rather the taxpayer sued for the balance of the purchase price and the purchasers counterclaimed to get their money back (Ex. Vol. 18, 35-36, 16-17). In its decision, this Court held that

> "there need have been no specific provision for liquidated damages in any of the escrow agreements." (1489)

The cases relied upon by this Court for that holding, which is at the heart of the Court's decision, are Binns v. U.S., 385 F.2d 159 (6th Cir. 1967); Smith v. Commissioner, 50 T.C. 273 (1968), aff'd 418 F.2d 573 (9th Cir. 1969); Melone v. Commissioner, 45 T.C. 501 (1966); Myers v. Commissioner, 287 F.2d 400 (6th Cir.) Cert. denied 368 U.S. 828 (1961); and U.S. Freight Co. v. United States, 422 F.2d 887, 893-894 (Ct. Cl. 1970) (1489). In every one of those cases, however, an agreement had been reached between the purchaser and the seller that the amounts paid to the seller would be retained by him as liquidated damages. In Binns v. U.S., supra., the purchaser had written to the seller after the default requesting him to accept the down payment as forfeited in return for the release of the purchaser from any further liability. The Tax Court, having found that such an agreement was reached, held that the sums were liquidated damages and thus ordinary income, pointing out that if the original sales

contract had contained a provision that the down payment would be forfeited as liquidated damages it would have been clear that such sums were ordinary income to the seller. The Circuit Court, affirmed, pointing out that the purchasers had

> "agreed to forfeit their down payment of $75,000 as consideration for their being released from further liability under the contract."

Likewise, in Melone v. Commissioner, supra., cited by this Court for the erroneous proposition that there need be no agreement that the sums paid to the seller be liquidated damages, the Tax Court treated as ordinary income "damages" which were paid to the taxpayer pursuant to a settlement agreement of an action which she had filed against the purchasers for breach of their agreement to purchase her property.

Likewise, in Myers v. Commissioner, supra., also cited by this Court for the asserted proposition that there need be no specific agreement for liquidated damages, the Circuit Court referred to the "mutual agreement" that the contract of sale was not to be carried out and that the seller could retain that part of the purchase price which had already been paid to him, thereby releasing the purchaser from further liability.

Likewise, in U.S. Freight Co. v. United States, supra., also relied upon by this Court for its holding, the Circuit Court there pointed out that pursuant to the terms of the purchase agreement the seller was to retain the initial payment on the purchase price of the stock as liquidated damages (422 F.2d at 891).

The Court there stated:

> "But where, as here, the buyer forfeits his down payment (accepted by the seller as liquidated damages in lieu of performance) upon breach and thereby relinquishes, in effect abandoning, his contract right of purchase, there has been no sale or exchange."

In the instant case, as is previously pointed out, there was no agreement, written or oral, that the purchasers were forfeiting their down payment or that the seller was accepting such down payment as liquidated damages in lieu of the purchasers' further performance. To the contrary, the taxpayer sued the purchasers and obtained a judgment for the balance of the purchase price.

The Tax Court found that, in the absence of an agreement, the taxpayer was not entitled, as a matter of state law, to retain the amounts received by him as liquidated damages, nor did the purchasers have the right to require the seller to accept the down payment in lieu of further performance of the purchase agreement (A. 169-170). That this is so is apparent from the decisions of the State Court in the two suits in which judgment was rendered to the taxpayer and Dr. Solomon. In the action brought by Dr. Solomon, which was decided first, the Appellate Division, First Department, stated:

> "Defendants desired to purchase the stock; they went to great efforts to do so. After they had defaulted on the... note, plaintiff could refuse to deliver the stock, at least after a reasonable time had elapsed (Personal Property Law, §132, 134, 141) ...By this new agreement, plaintiff gave up his

> accrued remedies as an unpaid seller... and defendants obtained the right to purchase the stock they desired within another two months." (250 N.Y.S. 2d at P.775)

The "remedies of an unpaid seller" referred to in the statute cited by the Appellate Division include the right of the seller to a possessory lien on the stock, the right to resell the stock to establish his damages, and the right to rescind the sale (Personal Property Law §134*) in addition to the right to sue for the unpaid balance of the purchase price (Personal Property Law §144). Pursuant to Personal Property Law §144(2), a suit for the balance of the purchase price requires the seller to manifest an ability to perform the contract by turning over the stock. Moreover, as the Tax Court pointed out, the choice by the taxpayer to rescind the contract would

> " ' be effective only by returning or turning back the consideration received.' Gilbert v. Rothschild, 80 N.Y. 66, 19 N.E.2d 785 (1939) and cases there cited." (A. 170)

Neither this Court, nor the Commissioner has referred to any provision of state law to the effect that the taxpayer, after the purchasers' default, had the right to claim forfeiture of the amounts paid by the purchasers. Thus,

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*During the relevant period, the sale of stock was governed by the Sales Act (Personal Property Law, §82 et seq.) See, Rosenzweig v. Salkind, 6 Misc. 2d 284, 158 N.Y.S.2d 522, reversed on other grounds 5 A.D.2d 58, 169 N.Y.S.2d 213, aff'd 5 N.Y.2d 902, 183 N.Y.S.2d 82. This is acknowledged by the Tax Court (A.168) as well as the Supreme Court, Appellate Division, First Department, which applied the Sales Act to the transaction in Solomon v. Van de Maele, supra.

as is pointed out by the Tax Court, the taxpayer was not in a position of keeping both the money and the stock, since under state law,

> "a provision for liquidated damages is never read into a contract by implication. People v. Condor of America, Inc.,252 N.Y.S.2d 619(Sup. Ct. 1964); see also Winkelman v. Winkelman, 204 N.Y.S.63 (Sup.Ct. 1924)". (A.170)

Accordingly, the unsupported holding by this Court that after the default, the taxpayer "became entitled to retain the original payment made to him on account of the purchase price" (1486), so that those payments were "in the nature of liquidated damages" (1489) constituted a clear error since that was not the case under state law, and since there was no agreement that the sums paid would be accepted by the seller as liquidated damages, as is evidenced by the fact that the taxpayer obtained a judgment for the balance of the purchase price. The granting of summary judgment to the taxpayer (as well as to Dr. Solomon) is inconsistent with this Court's holding since no such judgment would have been rendered if the amounts paid to the taxpayer were, as this Court held, "in the nature of liquidated damages". (1489)

This Court's error appears to have been committed partly as a result of a misapprehension as to the issues involved in the taxpayer's suit against the purchasers. This Court stated that the taxpayer's suit was based "not upon any purportedly enforceable contract of sale, but upon the three notes payable to him" (1486). To the contrary, one of the defenses alleged by the purchasers was that there was no enforceable contract of sale of the stock. In awarding

judgment to the taxpayer, the New York Supreme Court stated:

> "The defendants here urge the additional defenses of no consideration, and that in the event of nonpayment of the notes the stock was to be redelivered by the escrowee and held by plaintiff as the owner thereof. In effect, it is contended that there was in fact no sale. These defenses are integrated with those considered by the Appellate Division in the companion action, and as there stated, these defenses are also commercially incredible." (emphasis supplied)(Ex. Vol. 35)

Likewise, in the decision of the Appellate Division in Dr. Solomon's case, the Court stated:

> "Defendants are the makers who gave the note in purchase of... shares of stock in a corporation, Graphic Arts Exhibit Building, Inc., an enterprise created to erect a pavillion at the current New York Worlds' Fair"
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> ***
>
> "This ensued as part of the transactions which gave rise to several sales of stock, including the one in suit.
>
> ***
>
> "Defendants' desired to purchase the stock; they went to great efforts to do so." (250 N.Y.S. 2d at pp. 773-4)

In addition, this Court based its decision, in part, upon the false issue of whether a "sale or exchange" occurred as of the time of the purchasers' default, pointing out that the sales agreement was not then "consummated", that the "taxpayer retained all the voting rights to the stock" (1489) and that there was no delivery of the stock certificates "either endorsed or with accompanying assignment or power of attorney" (1489-1490). This Court thus concluded that all of the "benefits and responsibilities were retained by taxpayer at all times,

subject only to escrow of the stock against further payment of the notes that were not paid" (1490). It therefore found that the taxpayer held onto "the greater bundle of rights and attributes of ownership, including title, possession and management". (1490) It should first be pointed out that the Court was factually incorrect. In connection with each of the escrow agreements the taxpayer delivered to the escrow agent his stock, "duly endorsed in blank" (Ex. Vol. 69, 78, 79) thereby divesting himself of control over the corporation. The escrow agreement provided that voting rights with respect to certain shares would be exercised by the purchasers until a default occurred (Ex. Vol. 70), and provided for the taxpayer's delivering to the escrow agent of "an irrevocable proxy" (Ex. Vol. 70). The purchasers became officers of the corporation, obtained a $100,000 loan for the corporation, pledging a race house for that purpose, attempted to have a Texas bank lend additional monies to the corporation and as the taxpayer described it, by the time of the first default, "it was already their transaction for all apparent purposes". (A. 47-48) Indeed, as the Appellate Division pointed out,

> "During this period defendant O'Connor was heavily involved in the operation of the corporation, serving as its president." (250 NYS2d at p. 774)

In any event, the issue is not whether a sale had been consummated as of the time that the purchasers defaulted, but rather whether the contract of sale was eventually culminated. There can be no question that a "sale or exchange" is deemed to have occurred within the meaning of the Tax

laws, upon the making of the contract, even though title to the asset does not pass at that time. See e.g. Dakota Creek Lumber and Shingle Co. v. Commissioner of Internal Revenue, 26 B.T.A. 940, where part of the purchase price was paid upon making of the contract, but title did not pass until a later tax year. The Court there held:

> "(F)or income tax purposes the sale was completed in 1923 (when the contract was made), regardless of the fact that title had not passed to the vendee." *

This Court acknowledged that the taxpayer obtained a judgment against the purchasers on the unpaid notes, and that the taxpayer, in accordance with a settlement agreement of April 1970, turned over the stock certificates in consideration of a payment of approximately 65% of the judgment(which was accepted because of the difficulties encountered in the collection). The Court concluded, however, that by this time the corporation had become a "dessicated shell", and that the settlement, can not serve retroactively to create a sale or exchange where none occurred in the first instance" (1490). The cases cited hereinabove, however, indicate that where the sales transaction is eventually consummated, and title is eventually passed, the sale for tax purposes will be deemed to have occurred at the time that the contract was made. Moreover, the fact that the World's Fair was over by the time that a judgment was rendered against the purchasers

*For the same proposition, see:
Davidson & Case Lumber Company v. Motter, 14F. 2d 137; J. T. Pittard, 5 B.T.A. 929: Seletha O. Thompson, 9 B.T.A. 1342; Old Farmers Oil Company, 12 B.T.A. 203 ; Grace Harper Lumber Company, 14 B.T.A. 996; Bailey, et al., 18B.T.A. 105 ; Federal Development Co. 18B.T.A. 971; Harris Trust & Savings Bank, 24 B.T.A. 498; W.H. Hay, 24 B.T.A. 96. See also Pacheco Creek Orchard Co., 12 B.T.A. 1358.

in 1966 (Vol. 18-19), and that the corporation was thus defunct when payment on the judgment was finally made in April, 1970, is completely irrelevant. The New York court required the purchasers to comply with the terms of their agreement despite the fact that the stock had become worthless with the passage of time. Indeed, the taxpayer's decision to sue the purchasers for the balance of the purchase price, rather than to tender back the consideration received and rescind the sale, was motivated by the fact that the activities of the purchasers in managing the corporation had resulted in its having become "dessicated". As the Tax Court states:

> "Obviously, it was to the advantage of the petitioner not to claim a forfeiture but rather to proceed with the collection of the notes, in which event the petitioner would have to be prepared to make delivery of the stock. It is immaterial that when the litigation was finally settled the time for erecting the building at the New York Worlds' Fair had expired and the stock had become worthless. The fact that the buyers were forced to bear that risk confirms our conclusion that the sum of $95,000 received by the petitioner constituted a long-term gain from the sale of a capital asset within the meaning of section 1222." (A.170-171)

Accordingly, the sums received by Petitioner were not in the nature of liquidated damages, either by virtue of any agreement to that effect or by virtue of State law. The fact that the taxpayer was awarded a judgment for the balance of the purchase price demonstrates beyond dispute that the amounts paid to taxpayer were not liquidated damages, since if they were, the purchasers would have been free of further liability. Under State law

taxpayer's options at the time of default were to either rescind the sale, which would have required his tendering back the sums he received, or sue for the balance of the agreed price, in which event he had to tender the stock certificates to the purchasers. Taxpayer chose the latter option, was awarded a judgment, and turned over his stock to the purchasers as part of a compromise of that judgment. Thus the sums received by him were partial payment for the "sale" of stock, albeit the sale was consummated, from the purchasers' standpoint, as a result of legal compulsion. That it was eventually a forced sale does not make it any less of a sale.

CONCLUSION

In light of the above, Appellee respectfully requests that this Court grant the within application for a rehearing and a rehearing en banc, and that the portion of the judgment below respecting the stock transaction, be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this Petition for Rehearing and Rehearing En Banc has been made on opposing counsel by mailing three copies thereof on this 10th day of February, 1975 in an envelope with postage prepaid, properly addressed as follows:

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